10

Loss Restrictions: Passive Activities and At-Risk Limits

The passive activity law was legislated to discourage tax-shelter investments, but its reach went beyond tax shelters to cover all real estate investors and persons who invest in businesses as "silent partners" or who are not involved full time in the business. The passive activity law prevents an investor from deducting what the law defines as a passive loss from salary, self-employment income, interest, dividends, or retirement income. Such losses are deductible only from income from other passive activities. Losses disallowed by the passive activity rules are suspended and carried forward to later taxable years and become deductible only when passive income is realized or substantially all of the activity is sold.

Casualty and theft losses are not passive losses unless they are of the type usually occurring in a business, such as shoplifting theft losses.

On your tax return, passive income items and allowable deductible items are reported as regular income and deductions. For example, rental income and allowable deductions are reported on Schedule E. However, before you make these entries, you may have to prepare Form 8582, which identifies your passive income and losses and helps you to determine whether passive loss items are deductible.

Passive Activity Restrictions

¶10.1 Rental Activities

Rental income and losses are automatically treated as passive unless they are earned or incurred by a professional real estate person (¶10.3) or the rentals are considered by law to be business activity as discussed below. Even where rental income or loss is earned by a professional or is considered to be business income, the passive loss restrictions may still apply if the material participation activity rules of ¶10.6 are not met.

If you are not a real estate professional and have real estate rental losses, you may be able to deduct without restriction a loss of up to $25,000 under the rules of ¶10.2.

The passive activity rules apply to rental income and losses from rentals of apartments and commercial office space (whether long- or short-term); long-term rentals of office equipment, automobiles, and/or a vessel under a bareboat charter or a plane under a dry lease (no pilot or captain and no fuel); and net-leased property. A property is under a net lease if the deductions (other than rents and reimbursed amounts) are less than 15% of rental income or where the lessor is guaranteed a specific return or is guaranteed against loss of income.

Rentals treated as business activity. Although rental activities are generally treated as "passive," the following seven activities are excluded from the category of rental activity. However, income or loss from these activities may still be tainted as passive income or loss if you fail to meet one of the business material participation tests of ¶10.6.

1. **Incidental rental of investment property, property used in a business, or property rented to an employee for the convenience of an employer.** The rental of investment property is treated as a business activity if the principal purpose for holding the property during the tax year is to realize gain from its appreciation, and the gross rental income from the property for the tax year is less than 2% of the lower of the unadjusted basis of the property and fair market value of the property. The rental of business property is treated as incidental if the property was predominantly used in a business during the tax year or during at least two of the five tax years that immediately precede the tax year and gross rental income from the property for the tax year is less than 2% of the lesser of the unadjusted basis of the property and the fair market value of the property.

EXAMPLE

Kyle Gail owns unimproved land with a fair market value of $400,000 and an unadjusted basis of $300,000. He holds it for the principal purpose of realizing gain from its appreciation. To help reduce the cost of holding the land, he leases it to a rancher for grazing purposes at an annual rental of $3,500. The gross rental income of $3,500 is less than 2% of the lower of the fair market value and the unadjusted basis of the land. The rental of the land is not a rental activity.

2. **The average period of customer use of the property is seven days or less.** You figure the average for the year by dividing the aggregate number of days in all periods of customer use for the property that end during the tax year by the number of the periods of customer use. Each period during which a customer has a continuous or recurring right to use the property is treated as a separate period.

   This exception covers short-term rentals of vacation units, autos, video cassettes, tuxedos, and hotel and motel rooms. If you own a vacation rental unit rented out for periods of seven days or less at a loss, the loss is treated as a business loss deductible from nonpassive income if you meet the material participation tests of ¶10.6. The loss also does not qualify for the up-to-$25,000 rental loss allowance discussed in ¶10.2.

EXAMPLE

In 1985, the Toups purchased a cottage in Callaway Gardens, a vacation resort south of Atlanta, Georgia. The unit was rented for short-term periods of seven days or less during the year to resort guests. The resort's operator was the sole managing and rental agent. Over a three-year period, they deducted net losses of $46,848. The IRS disallowed the losses as passive activity losses. The Toups argued that they were not passive investors but material participants in the operation. They claimed they spent more than 300 hours each year preparing an annual budget and cash flow analysis and meeting with other owners to set rentals and inspect the grounds.

The Tax Court sided with the IRS. The losses were passive because the Toups did not materially participate in the resort operation. They had nothing to do with running the resort on a day-to-day basis. Their activity was merely that of investors.

3. **The average period of customer use of the property is more than seven days but is 30 days or less, and you provide significant personal services.** Personal services include only services performed by individuals and do not include (a) services necessary to permit the lawful use of the property; (b) construction or repair services that extend the useful life of the property for a period substantially longer than the average period of customer use; and (c) services that are provided with long-term rentals of high-grade commercial or residential real property such as cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security guards.
4. **Regardless of the average period of customer use, extraordinary personal services are provided so that rental is incidental.** This applies to institutions providing hospital patients room and board.

Note: For purposes of Exceptions 2 and 3, if more than one class of property is rented as part of the same activity, average period of customer use is figured separately for each class. The average period of customer use (as explained in Exception 2) is multiplied by the ratio of gross rental income from that class to the total rental income from the activity; *see* the Form 8582 instructions.

5. **Providing property to a partnership or S corporation which is not engaged in rentals.** If you own an interest in a partnership or S corporation and you contributed property to it as an owner, the contributed property is not considered a rental activity. For example, if as a partner you contribute property to a partnership, your distributive share of partnership income will not be considered as income from a rental activity. However, this exception will not apply if the partnership is engaged in a rental activity.
6. **The property is generally allowed for the nonexclusive use of customers during fixed business hours** such as operating a golf course. The customers are treated as licensees, not lessees.
7. **Rental of personal residence.** Rental of a personal residence is not treated as a passive rental activity if you personally use the home for more than the greater of either (1) 14 days, and (2) 10% of the days the home is rented for a fair rental amount. With such personal use, rental deductions are limited to gross rental income under the vacation home restrictions of ¶29.20. Furthermore, mortgage interest is generally fully deductible provided the rented home is a principal or second residence; *see* ¶15.1.

Grouping rental and nonrental business activities. Where you conduct rental as well as nonrental business activities, you may not group a rental activity with a nonrental activity, unless one of the activities is considered insubstantial in relation to the other. No guidelines are provided for determining what is "substantial" or "insubstantial." However, an IRS guide used by examining agents suggests that an auditor might develop his or her case by applying a prior law test of 80%/20%; where 80% of the gross income at one location was from either rentals or business, the activities were grouped together.

Under an exception, a rental of property to a business may be grouped together with the business, although one activity is insubstantial to the other, provided each owner has the same proportionate ownership in the rental activity.

Real property rentals and personal property rentals. An activity involving the rental of realty and one involving the rental of personal property may not be treated as a single activity, unless the personal property is provided in connection with the real property or the realty is provided in connection with the personal property.

¶10.2 Rental Real Estate Loss Allowance of Up to $25,000

If you are not a real estate professional (¶10.3) but perform some management role in a real estate rental venture, you may deduct up to $25,000 of a real estate rental loss against your regular, nonpassive income such as wages. The loss allowance is claimed on Form 8582. The allowance is phased out if your modified adjusted gross income is between $100,000 and $150,000.

The allowance applies only to real estate rentals not excluded from the rental category by the rules of ¶10.1. For example, short-term rentals of seven days or less do *not* qualify for the allowance. The allowance also does not apply to any rentals of equipment or other personal property.

A trust may not qualify for the $25,000 allowance. Thus, you may not circumvent the $25,000 ceiling or multiply the number of $25,000 allowances by transferring rental real properties to one or more trusts. However, an estate may qualify for the allowance if the decedent actively participated in the operation. The estate is treated as an active participant for two years following the death of the owner.

Allowance Based on Income

The rental loss allowance is phased out when your modified adjusted gross income is over $100,000. For every dollar of income over $100,000, the loss allowance is reduced by 50 cents. When your modified adjusted gross income reaches $150,000, the allowance is completely phased out. An explanation of modified adjusted gross income and an example of how the phaseout works is under the heading "Phaseout of the allowance."

If modified AGI is—	*Loss Allowance is—*
Up to $100,000	$25,000
110,000	20,000
120,000	15,000
130,000	10,000
140,000	5,000
150,000 or more	–0–

Married filing separately. If you file separately and at any time during the taxable year live with your spouse, you may not claim the allowance. If you are married but live apart from your spouse for the entire year and file a separate return, the $25,000 allowance and the adjusted gross income phase-out range are reduced by 50%. Thus, the maximum allowance on your separate return is $12,500 and this amount is phased out by 50% of AGI over $50,000. Therefore, if your AGI exceeds $75,000, no allowance is allowed.

Qualifying for the allowance. To qualify for the allowance, you must meet an *active participation test.* Having an agent manage your property does not prevent you from meeting the test. You may meet the test by showing that you or your spouse participates in management decisions, such as selecting tenants, setting rental terms, and reviewing expenses. However, the IRS may not recognize your activity as meeting the test if you merely ratify your manager's decisions. You (together with your spouse) must also have at least a 10% interest in the property. Limited partners are not considered active participants and do not qualify for the allowance.

If a decedent actively participated in property held by an estate, the estate is deemed to actively participate for the two years following the death of the taxpayer.

EXAMPLES

1. You live in New York and own a condominium in Florida that you rent through an agent. You set the rental terms and give final approval to any rental arrangement. You also have final approval over any repairs ordered by the agent. You are an active participant and may claim the $25,000 rental allowance.
2. A married couple who owned a time-share interest in an oceanfront condominium rented the condo during their allotted period to vacationers. They claimed a rental loss which the IRS held did not qualify for the up-to-$25,000 allowance. Since the average rental period for their unit was seven days or less, the rentals were excluded from the category of rental activity; *see* ¶10.1.

Figuring the $25,000 allowance. First match income and loss from all of your rental real estate activities in which you actively participate. A net loss from these activities is then applied to net passive income (if any) from other activities to determine the $25,000 allowance. Gains from pre-1987 installment sales are passive income if the sold property was from an activity that would have been considered passive had the passive activity rules been in effect before 1987. If you rent out a personal residence, rental income or loss may be exempt from the passive activity rules; *see* Exception 7 at ¶10.1. The allowance may not be used against carryover losses from prior taxable years when you were not an active participant.

EXAMPLE

David Chung has a $90,000 salary, $15,000 income from a limited partnership, and a $26,000 loss from rental real estate in which he actively participated. The $26,000 loss is first reduced by the $15,000 of passive income. The remaining balance of the $11,000 rental loss is deducted from the salary income.

Phaseout of the allowance. For purposes of the allowance phaseout, *modified adjusted gross income* (MAGI) is adjusted gross income shown on your return, but you should disregard:

Any passive activity income or loss.

Any loss allowed under ¶10.3 for real estate professionals.

Taxable Social Security and railroad retirement payments (Chapter 34). For example, if your adjusted gross income on Form 1040 is $90,000, and that includes $5,000 of taxable Social Security benefits, your modified adjusted gross income is $85,000.

Deductible IRA contributions (Chapter 8).

The deduction on Form 1040 for one-half of self-employment tax liability (Chapter 46).

Excluded interest on U.S. Savings Bonds used for paying tuition in the year the bonds are redeemed. If you are allowed to exclude the interest from income for regular tax purposes (Chapter 33) the interest must still be included for purposes of the allowance phaseout.

A rental loss which is carried over because it exceeds the allowance may be deductible in a later year if you continue to meet the active participant rule.

EXAMPLES

1. In 1996, Liz Blake had $120,000 in salary, $5,000 of partnership income from a limited partnership and a $31,000 loss from a rental building in which she actively participates. She may deduct only $15,000 of the rental loss. The remaining $11,000 must be carried over to 1997. Her deduction and carryover are computed as follows:

Modified adjusted gross income	$120,000
Less: amount not subject to phaseout	100,000
Amount subject to phaseout	$ 20,000
Phase-out percentage	50%
Portion of allowance phased out	$ 10,000
Maximum rental allowance offset	$ 25,000
Less: amount phased out	10,000
Deductible rental loss allowance offset in 1996	$ 15,000
Passive loss from rental real estate	$ 31,000
Less: passive income from partnership	5,000
Passive activity loss	$ 26,000
Less: deductible rental loss allowance in 1996	15,000
Carryover loss to 1997	$ 11,000

2. In 1997, Liz's modified adjusted gross income was below the phase-out range and she continued to actively participate in the rental building, which incurred a loss of $5,000. Under the allowance, she may deduct a rental loss of $16,000 (the current loss plus the carryover loss).

Real estate allowance for tax credits. On Form 8582-CR, a deduction equivalent of up to $25,000 may allow a credit that otherwise would be disallowed. You must meet the active participation test in the year the credit arose. The $25,000 allowance is generally subject to the regular MAGI phase-out rule.

To claim low-income housing and rehabilitation credits (¶9.8). you need not meet the active participant test. Furthermore, for rehabilitation credits, and credits for low-income housing property placed in service before 1990, the phaseout for the $25,000 allowance starts at MAGI of $200,000 ($100,000 if married filing separately and living apart the entire year); thus, the deduction

equivalent is completely disallowed when MAGI reaches $250,000. The phaseout is figured on Form 8582-CR. There is no MAGI phaseout for low-income housing property placed in service after 1989, unless you have a pass-through interest in a partnership or S corporation that you acquired before 1990. No low-income housing credit may be claimed for an investment exempted from the passive activity rules under ¶10.14.

The *deduction equivalent* of a credit is the amount which, if allowed as a deduction, would reduce your tax by an amount equal to the credit. For example, a tax credit of $1,000 for a taxpayer in the 28% bracket equals a deduction of $3,571 and would come within the $25,000 allowance provided you actively participated. In the 28% bracket, the equivalent of a $25,000 deduction is a tax credit of $7,000 ($25,000 × 28%). Thus, if you have a rehabilitation credit of $8,000 and you are in the 28% bracket, the $25,000 allowance may allow you to claim $7,000 of the credit, while $1,000 of the credit would be carried forward to the following year.

If in one year you have both losses and tax credits, the $25,000 allowance applies first to the losses, then to tax credits from rental real estate with active participation, then to tax credits for rehabilitation or low-income housing placed in service before 1990, and finally to tax credits for low-income housing placed in service after 1989.

The allowance and net operating losses. If losses are allowed by the $25,000 allowance but your nonpassive income and other income are less than the loss, the balance of the loss may be treated as a net operating loss and may be carried back and forward; *see* ¶40.17 for further details.

¶10.3 Real Estate Professionals

You may be able to treat rental real estate income and loss as nonpassive income and loss by meeting the following two tests:

Test 1. Your personal services in real estate businesses meet the 50% and 750 hours tests explained below.

Test 2. You materially participate in the rental real estate activity. Here, you consider only services in the rental activity. You may not combine hours of participation in nonrental activities with rental real estate activities to meet this test. To meet the material participation requirement, you may make an election to aggregate all of your rental real estate activities.

The material participation tests applied to real estate businesses and real estate rental activities are the same as applied to non–real estate businesses as explained at ¶10.6.

Qualifying as a real estate professional (Test 1). You must meet the following two activity tests:

1. More than 50% of your personal services in all of your businesses must be performed in real property businesses in which you materially participate (¶10.6). For this purpose, a real property business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental operation, management, leasing, or brokerage trade or business. Real estate financing is not included; and
2. More than 750 hours of your services are in real property businesses in which you materially participate (¶10.6).

For a married couple filing jointly, both the "50% of services test" and the "750 hours test" must be met by one of the spouses individually, without regard to the other spouse's services, although the other spouse's participation counts in determining whether you materially participate in the real property businesses under Test 2.

Personal services performed as an employee are not treated as performed in a real estate business unless you are considered a "more than 5% owner" in the employer. That is, you must own more than 5% of the outstanding stock or more than 5% of total combined voting powers of all stock issued by the corporation. In a noncorporate employer such as a partnership, you must own more than a 5% capital or profit interest.

A closely held C corporation qualifies under the real estate professional rules if in a taxable year more than 50% of the gross receipts of the corporation are from a real property business in which the corporation materially participates under the rules at ¶10.15.

Rental real estate activity material participation (Test 2). Generally, each interest in rental real estate property is treated as a separate activity. However, you may elect to treat all of your interests as one rental activity as discussed below. If, under the rules of ¶10.1, you group a rental real estate activity with a business activity, that rental activity is not treated as rental real estate for purposes of the real estate professional rules.

The ability to meet the material participation tests of ¶10.6 is greater by aggregating your rental real estate activities. However, you may not want to aggregate activities if you have passive losses from non–real estate activities and have rental income from an operation which if treated as passive income could be offset by the losses.

Also be aware that if you elect to group all of your rental real estate activities as one activity and later sell one of the rental properties, you will probably be unable to deduct suspended losses from that property because of the rule that requires "substantially all" of your interest in an activity (here, the combined activity) to be disposed of in order to deduct suspended losses; *see* ¶10.13.

An attorney who specializes in real estate practice and also participates in a rental business may not treat his legal practice as material participation for purposes of qualifying as a real estate professional.

Election to aggregate rental real estate activities. If in a prior year rental real estate activities were treated separately, you may elect to aggregate activities for any year you qualify as a real estate professional by attaching a statement to your original tax return for that year. The statement must contain a declaration that you are a qualifying real estate professional and are treating all of your rental real estate activities as a single activity under Internal Revenue Code Section 469(c)(7)(A). The election is binding for all future years in which you qualify as a real estate professional, even if there are intervening years in which you do not qualify. In the nonqualifying

years, the election has no effect. You may not revoke the election in a later year unless there has been a material change in circumstances that you explain in a statement attached to your original return for the year of revocation. That the election no longer gives you a tax advantage is not a basis for a revocation.

If the election to aggregate is made, prior-year suspended losses from any of the aggregated rental real estate activities may be used to offset net income in the current year from the aggregated activity, regardless of which of the rental activities produced the income.

Rental loss allowance may apply to nonqualifying rental activity. A real estate professional may also claim the $25,000 rental loss allowance. For example, you are a real estate professional and meet the material participation test for one rental real estate activity but not for another and do not elect to aggregate. Losses from the nonqualifying activity qualify for the rental allowance. Furthermore, suspended prior year losses from the qualifying activity may also be deductible under the rental loss allowance, as illustrated in the following Example.

EXAMPLE

Jane Morton owns a rental building in Manhattan and a rental building in Newark. In 1996, she qualifies as a real estate professional. She does not elect to treat the two buildings as one activity. She materially participates in the operations of the Manhattan building, which has $100,000 of disallowed passive losses from prior years and a $20,000 passive loss for 1996. She does not materially participate in the operation of the Newark building, which has $40,000 of rental income for 1996. Jane also has $50,000 of income from other nonpassive sources.

The $20,000 loss from the Manhattan building is treated as nonpassive and offsets $20,000 of the $50,000 nonpassive income from other sources.

Jane can also use $40,000 of the $100,000 prior year suspended losses from the Manhattan building to offset the $40,000 of passive income from the Newark building in 1996. Of the $60,000 remaining suspended loss, $25,000 may be deducted under the rental loss allowance.

The rental loss allowance is deducted from the $30,000 of remaining nonpassive income, leaving Jane with $5,000 of nonpassive income for 1996. The balance of suspended losses of $35,000 ($60,000 – $25,000 rental allowance) may be used in 1997 to offset income from the Newark building or passive income from other sources.

Interests in S corporations and partnerships. Your interest in rental real estate held by a partnership or an S corporation is treated as a single interest in rental real estate if the entity grouped its rental real estate as one rental activity. If not, each rental real estate activity of the entity is treated as a separate interest in rental real estate. However, you may elect to treat all interests in rental real estate, including the rental real estate interests held by an S corporation or partnership, as a single rental real estate activity.

If you hold a fifty-percent or greater interest in the capital, income, gain, loss, deduction, or credit in a partnership or S corporation for the taxable year, each interest in rental real estate held by the entity is treated as a separate interest in rental real estate, regardless of the entity's grouping of activities. However, you may elect to treat all interests in rental real estate, including your share of the rental real estate interests held by the entities, as a single rental real estate activity.

Limited partners. Generally, a person who has a limited partnership interest in rental real estate must establish material participation by participating for more than 500 hours during the year or meeting one of the seven regular tests of ¶10.6 during five of the preceding 10 years. This material participation rule also generally applies if an election is made to aggregate limited partnership interests in rental real estate with other rental real estate interests. However, these more stringent rules may be avoided if less than 10% of the gross rental income for the taxable year from all rental real estate activities is attributed to limited partnership interests. In such a case, you may make the election to aggregate all rental real estate activities and determine material participation under any of the seven tests of ¶10.6.

¶10.4 Participation May Avoid Passive Loss Restrictions

To avoid passive activity treatment of income and loss from a business investment, you must show material participation in that activity. The word "activity" does not necessarily relate to one specific business. If you invest in several businesses, you may be able to treat all or some of those activities as one activity or treat each separately.

Determining aggregate or separate treatment for your activities is discussed at ¶10.5 and material participation tests are discussed at ¶10.6.

For a rental activity, material participation tests apply only if you are trying to qualify for the passive activity exception for real estate professionals at ¶10.3. For other rental real estate operators or investors, an "active" participation test which requires only certain management duties may allow you to deduct rental losses of up to $25,000; *see* ¶10.2.

¶10.5 Classifying Business Activities as One or Several

If you are in more than one activity, determining aggregate or separate treatment is important for:

Deducting suspended losses when you dispose of an activity. If the activity is considered separate from the others, you may deduct a suspended loss incurred from that activity when you dispose of it. If it is not separate from the others, the suspended loss is deductible only if you dispose of substantially all of your investment; *see* ¶10.13.

Applying the material participation rules of ¶10.6. If activities are separate and apart from each other, the material participation tests are applied to each activity separately. If the activities are aggregated as one activity, material participation in one activity applies to all.

IRS RULES

Earmarking a business activity. You may use any reasonable method under the facts and circumstances of your situation to determine if several business activities should be grouped together or treated separately. To be grouped together, the IRS says that the activities should be "an appropriate economic unit" for measuring gain or loss. For making this determination, the IRS sets these general guidelines: (1) similarities and differences in types of business; (2) the extent of common control; (3) geographic location; (4) the extent of common ownership; and (5) interdependencies between the activities. Interdependency is measured by the extent to which several business activities buy or sell among themselves, use the same products or services, have the same customers and employees, or use a single set of books and records.

The IRS will not require that all five factors be present for grouping for multiple activities.

Rental activities. Rental activities may *not* be grouped with business activities unless one of the exceptions discussed at ¶10.1 applies.

Consistent treatment required. Once you treat activities separately or group them together as a single activity, the IRS generally requires you to continue the same treatment in later taxable years. You can regroup activities only if the original treatment was "clearly inappropriate" or has become clearly inappropriate because of a material change in circumstances.

EXAMPLE

Lance Jones has a significant interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. The IRS does not explain what constitutes a significant interest. In grouping his activities into appropriate economic units based on the relevant facts and circumstances, Jones could: (1) group the theaters and bakeries into a single activity; (2) place the two theaters into one group and the bakeries into a second group; (3) put his Baltimore businesses into one group and his Philadelphia businesses in another group; or (4) treat the two bakeries and two movie theaters as four separate activities.

Once he chooses a grouping, he must consistently use that grouping for all future years unless a material change makes the grouping inappropriate. His decision is also subject to IRS review and, if questioned, he must show the factual basis for his grouping.

IRS may regroup activities. The IRS may regroup your activities if your grouping does not reflect one or more appropriate economic units and a primary purpose of the grouping is to circumvent the passive loss rules.

EXAMPLE

Five doctors operate separate medical practices and also invest in tax shelters that generate passive losses. They form a partnership to operate X-ray equipment. In exchange for the equipment contributed to the partnership, each doctor receives limited partnership interests. The partnership is managed by a general partner selected by the doctors. Partnership services are provided to the doctors in proportion to their interests in the partnership and service fees are set at a level to offset the income generated by the partnership against individual passive losses. Under these facts, the IRS will not allow the medical practices and the partnership to be treated as separate activities as this would circumvent the passive loss limitations by generating passive income from the partnership to offset the tax-shelter losses. The IRS will require each doctor to treat his or her medical practice and interests in the partnership as a single activity.

Partnerships and S corporations. A partnership or S corporation must group its activities under the facts and circumstances test. Once a partnership or S corporation determines its activities, the partners or shareholders are bound by that decision and may not regroup them. The partners and shareholders then apply the facts and circumstances test to combine the partnership or S corporation activities with, or separate them from, their other activities.

Special rule for certain limited partners and limited entrepreneurs. A limited entrepreneur is a person with an ownership interest who does not actively participate in management. A limited entrepreneur or limited partner in films, videotapes, farming, oil and gas, or the renting of depreciable property generally may combine each such activity only with another of such activities in the same type of business, and only if he or she is a limited entrepreneur or partner in both. Grouping of such activities with other activities in the same type of business in which he or she is *not* a limited partner or entrepreneur is allowed if the grouping is appropriate under the general facts and circumstances test.

¶10.6 Material Participation Tests for Business

The IRS has seven tests for determining material participation in a business. Some tests require only a minimum amount of work, such as 500 hours a year and others only 100 hours. You need to meet only one of the seven tests to qualify as a material participant. If you do, then the income and loss from that business is treated as *nonpassive*.

The tests apply whether you do business as a sole proprietor, in an S corporation, or partnership. Losses and credits passed through S corporations and partnerships are subject to passive activity rules.

Material participation must be determined on an annual basis. Show proof of your participation by keeping an appointment book, calendar, or log of the days and time spent in the operation.

If you are a limited partner, you are not by law a material participant unless you satisfy certain conditions discussed at ¶10.11.

Your tax position towards the IRS participation rules will depend on whether the particular activity produces income or loss. If you have passive activity losses from other activities, you may prefer to

have a profitable business activity treated as a passive activity in order to offset the income by the losses from passive activities. On the other hand, if the business activity operates at a loss and you do not have passive income from other sources, you may want to meet the material participation test for that business activity in order to claim current loss deductions. IRS strategy in reviewing your activities would be the opposite. If your return was under audit, an agent would attempt to prevent you from treating income from a business activity as passive. For example, the IRS, by applying Tests 5 and 6, can prevent a retired person from treating post-retirement income from a prior business or profession as passive income to offset passive losses from another activity. If you realize a loss in one passive activity, Test 4 may prevent you from generating passive income by merely reducing your participation in another activity.

Material participation results in nonpassive treatment. There are two key terms: material participation and significant participation. If you materially participate by meeting one of the seven IRS tests, your activity is not a passive activity. For example, under Test 1, work for more than 500 hours in an activity is considered material participation. Under Test 4, significant participation is work for more than 100 hours but less than 500 hours at an activity in which you do not otherwise materially participate. The IRS applies a significant participation rule to convert passive activity income into nonpassive income and to convert several significant participation activities into material participation if the total participation in those activities exceeds 500 hours; *see* Test 4.

Work by you or your spouse. Any work you do in a business you own is treated as "participation." If you are married, work by your spouse in the activity during the tax year is treated, for purposes of the following tests, as participation by you. This is true even if your spouse does not own an interest in the business or if you file separately. However, the following type of work is *not* treated as participation:

1. Work that is not of a type customarily done by an owner of an activity, if one of the principal reasons for the performance of the work is to avoid the passive loss rules (*see* the Example below).
2. An investor's review of financial statements or analysis which is unrelated to day-to-day management or operation of the activity.

EXAMPLE

An attorney, owns an interest in a professional football team for which he performs no services. He anticipates a net loss from the football activity and to qualify as a material participant, he hires his wife to work 15 hours a week as an office receptionist for the team. Although a spouse's participation in an activity generally qualifies as participation by both spouses, the receptionist work here does not qualify as participation because (1) it is not the type of work customarily done by an owner of a football team, and (2) the attorney hired his spouse to avoid disallowance of a passive loss.

IRS TESTS FOR MATERIAL PARTICIPATION

If you meet one of the following tests for the year in question, you are considered to have materially participated in that activity, and therefore the activity is considered *nonpassive* for that year. Tests 5 and 6 prevent retired individuals from treating post-retirement income as passive income.

Test 1. You participate in the activity for more than 500 hours during the tax year.

Test 2. Your participation in the activity for the tax year constitutes substantially all of the participation in the activity of all individuals including non-owners for the year.

Test 3. You participate in the activity for more than 100 hours during the tax year, and your participation is at least as great as that of any other person including non-owners for that year.

EXAMPLE

Joan Brown and Pat Collins are partners in a moving van business which they conduct entirely on weekends. They both work for eight hours each weekend. Although neither partner participates for more than 500 hours (Test 1), they are each treated as material participants under Test 3 because they participate for more than 100 hours and no one else participates more.

Test 4. You are active in several enterprises but each activity does not in itself qualify as material participation. However, if you spend more than 100 hours in each activity and the total hours of these more-than-100-hours activities exceeds 500, you are treated as a material participant in each of these activities. This test is described as the significant participation test.

EXAMPLES

1. Mike Smith is a full-time accountant with ownership interests in a restaurant and shoe store. He works 150 hours in the shoe store and 360 hours in the restaurant. Under the significant participation test (Test 4), Smith is considered a material participant in both activities, as the total hours of both exceed 500.
2. Carl Young invests in five businesses. In activity (a) he works 110 hours; in activity (b), 100 hours; in activity (c), 125 hours; in activity (d), 120 hours; and in (e), 140 hours. He does not qualify under the significant participation test (Test 4). Although his total hours in the five activities exceed 500, activity (b) is ignored in the total count because the hours did not exceed 100. The total of the four other activities is 495.
3. Assume that Young worked one hour more for activity (b). It and all of the other activities would be considered as meeting the material participation test. The total hours are 596. Assuming that activity (a) totaled 125 hours and activity (b) remained at 100 hours or less, he would meet the test for all of the activities except for activity (b), which did not exceed 100 hours. The total of the four qualified activities is 510 hours.

Test 5. You materially participated in the activity for any five tax years during the 10 tax years preceding the tax year in question. The five tax years do not have to be consecutive. Use only Test 1 for determining material participation in years before 1987. Thus, if you are retired but meet the five-out-of-10-year participation test, you are currently considered a material participant, with the result that net income is treated as nonpassive, rather than passive. If you retired from a personal service profession, an even stricter rule applies; *see* Test 6.

Test 6. In a personal service activity, you materially participated for any three tax years preceding the tax year in question. The three years do not have to be consecutive. Use only Test 1 for determining material participation in years before 1987. Examples of personal services within this test are the professions of health, law, engineering, architecture, accounting, actuarial science, the performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.

Test 7. Under the facts and circumstances test, you participate in the activity on a regular, continuous, and substantial basis. *According to the IRS, you do not come within this test if you participate less than 100 hours in the activity.*

The IRS will not recognize time spent as an investor unless you can show you are involved in daily operations or management of the activity. According to the IRS, this requires you to be at the business site on a regular basis. Even if you do appear daily, the IRS may ignore such evidence if there is an on-site manager or you have full-time business obligations at another site. Activity of an investor includes the studying and reviewing of financial reports for your own use which are considered unrelated to management decisions. If you invest in a business that is out of state or a distance from your home, you may also find it difficult to prove material participation.

If you want to treat contacts by phone as material activity, keep a log of phone calls showing the time and purpose of the calls.

Retired farmers. Retired or disabled farmers are treated as materially participating in a farming activity if they materially participated for five of the eight years preceding their retirement or disability. A surviving spouse is also treated as materially participating in a farming activity if the real property used in the activity meets the estate tax rules for special valuation of farm property passed from a qualified decedent and the surviving spouse actively manages the farm.

Limited partners; *see* ¶10.11.

Participant rules for personal service and closely held corporations; *see* ¶10.15.

¶10.7 Tax Credits of Passive Activities Limited

You may generally not claim a tax credit from a passive activity unless you report and pay taxes on income from a passive activity. Furthermore, the tax allocated to that income must be at least as much as the credit. If the tax credit exceeds your tax liability on income allocable to passive activities, the excess credit is not allowed. Use Form 8582-CR to figure the allowable credit. Suspended credits are not allowed when property is disposed of. The credits may be used only when passive income is earned.

EXAMPLE

Ben Wall has a $1,000 credit from a passive activity. He does not report income from any passive activity. He may not deduct the credit because no part of his tax is attributed to passive activity income. The credit is suspended until he has income from a passive activity and he incurs tax on that income. All or part of the credit may then be claimed to offset the tax. If he disposed of his interest before using a suspended credit, the credit may no longer be claimed but the election to reduce basis, discussed below, could be made.

Credits for real estate activities. As discussed at ¶10.2, more favorable tax credit rules apply to real estate activities.

Basis adjustment for suspended credits. If the basis of property was reduced by tax credits, you may elect on Form 8582-CR to add back a suspended credit to the basis when your entire interest in an activity is disposed of.

EXAMPLE

Mark places in service rehabilitation credit property and claims an allowable credit of $50, which also reduces basis by $50. However, under the passive loss rule, he is prevented from claiming the credit. In a later year, he disposes of his entire interest in the activity, including the property whose basis was reduced. He may elect to increase basis of the property by the amount of the original basis adjustment.

If the property is disposed of in a transaction that is not treated as a fully taxable disposition under ¶10.13, then no basis adjustment is allowed.

¶10.8 Nonpassive Income and Losses

The purpose of the passive loss rules is to prevent you from deducting passive losses from nonpassive income. Passive losses are generally losses from business activities in which you do not materially participate or from rental activities which generate losses which are not deductible under the $25,000 allowance or do not qualify you as a real estate professional. In some cases, as explained in ¶10.9, passive income may be treated as nonpassive income.

Where you do not materially participate in a business activity, passive income or loss is determined by matching income and expenses of that activity. Portfolio income earned by the activity or any pay that you earn is not included to determine passive income or loss.

Portfolio income is nonpassive income and broadly defined as income that is not derived in the ordinary course of business of the activity. Portfolio income includes interest, dividends, annuities, and royalties from property held for investment. However, interest income on loans and investments made in the business of lending money or received on business accounts receivable is generally not treated as portfolio income; *see* ¶10.9 for special recharacterization rules. Similarly, royalties derived from a business of licensing property is not portfolio income to the person who created the property or performed substantial services or incurred substantial costs.

Portfolio income also includes gains from the sale of properties that produce portfolio income or are held for investment.

Expenses allocable to portfolio income, including interest expenses, do not enter into the computation of passive income or loss.

Dealers. Sales income of a dealer is generally treated as business income except for the sale of property that was held by the dealer as investment property at any time before the sale of the property.

Sale of property used in activity. Gain realized on the sale of property used in the activity is treated as passive activity income if at the time of disposition the activity was passive; *see* the exception at ¶10.16. Under this rule, if you transact an installment sale, the treatment of installment payments depends on your status at the time of the initial sale. If you were not a material participant, installment payments in a later year are treated as passive income, even if you become a material participant in the later years.

Installment payments from a pre-1987 installment sale are treated as passive income if the activity would have been considered passive had the passive activity rules been in effect before 1987.

Although gain on the sale of property is generally passive income if the activity is passive at the time of sale, there is an exception that could recharacterize the gain as nonpassive income if the property was formerly used in a nonpassive activity; *see* ¶10.16 for details.

Compensation for personal services is not passive activity income. The term "compensation for personal services" includes only (1) earned income, including certain payments made by a partnership to a partner and representing compensation for the services of the partner; (2) amounts included in gross income involving the transfer of property in exchange for the performance of services; (3) amounts distributed under qualified plans; (4) amounts distributed under retirement, pension, and other arrangements for deferred compensation of services; and (5) Social Security benefits includible in gross income.

Passive activity gross income also does not include (1) income from patent, copyright, or literary, musical, or artistic compositions, if your personal efforts significantly contributed to the creation of the property; (2) income from a qualified low-income housing project; (3) income tax refunds; and (4) payments on a covenant not to compete.

Payments made under a covenant not to compete are not passive income.

Passive activity deductions. Deductible expenses that offset passive income of an activity must be related to the passive activity, such as real property taxes. The following are *not* considered passive activity deductions:

Casualty and theft losses if similar losses do not recur regularly in the activity.
Charitable deductions.
Miscellaneous itemized deductions subject to the 2% AGI floor.
State, local, and foreign income taxes.
Carryovers of net operating losses or capital losses.
Expenses clearly and directly allocable to portfolio income.
Loss on the sale of property producing portfolio income.
Loss on the sale of your entire interest in a passive activity to an unrelated party. The loss is allowed in full; *see* ¶10.13.

Interest deductions. Interest expenses attributable to passive activities are treated as passive activity deductions and are not subject to the investment interest limitations. For example, in 1996, if you have net passive loss of $100, $40 of which is of interest expense, the entire $100 is a passive loss. $40 of the loss is not subject to the investment interest limitation of ¶15.10. Similarly, income and loss from passive activities generally are not treated as investment income or loss in figuring the investment interest limitation.

Interest expenses for a vacation home elected as a qualified second residence are not treated as passive activity interest and are deductible as residential interest; *see* ¶15.1 and ¶29.20.

¶10.9 Passive Income Converted Into Nonpassive Income

There is an advantage in treating income as passive income when you have passive losses that may offset the income. However, the law may prevent you from treating certain income as passive income. The conversion of passive income to nonpassive income is technically called "recharacterization." This may occur when you do not materially participate in the business activity, but are sufficiently active for the IRS to consider your participation as significant. Recharacterization may also occur when you rent nondepreciable property or sell development rental property. As discussed at ¶10.16, gain on the sale of property used in a passive activity may be recharacterized as nonpassive income if the property was formerly used in a nonpassive activity.

Significant participation. The IRS compares income and losses from all of your activities in which you work more than 100 hours but less than 500 and which are not considered material participation under the law. If you show a net aggregate gain, part of your gain is treated as nonpassive income according to the computation illustrated in the following Example.

EXAMPLE

Carol Warren invests in three business activities—A, B, and C. She does not materially participate in any of the activities during 1996 but participates in Activity A for 105 hours, in Activity B for 160 hours, and in Activity C for 125 hours. Her net passive income or loss from the three activities is:

	A	B	C	Total
PA gross income	$600	$ 700	$900	$2,200
PA deductions	(200)	(1,000)	(300)	(1,500)
Net passive income	$400	($ 300)	$600	$ 700

Carol's passive activity gross income from significant participation passive activities of $2,200 exceeds passive activity deductions of $1,500. A ratable portion of her gross income from significant participation activities with net passive income for the tax year (Activities A and C) is treated as gross income that is not from a passive activity. The ratable portion is figured by dividing:

1. The excess of her passive activity gross income from significant participation over passive activity deductions from such activities (here $700) by
2. The net passive income of only the significant participation passive activities having net passive income (here $1,000). The ratable portion is 70%.

Thus, $280 of gross income from Activity A ($400 × 70%) and $420 of gross income from Activity C ($600 × 70%) is treated as nonpassive gross income. This adjustment prevents $700 from being offset by passive losses from another activity.

Net interest income from passive equity-financed lending. Gross income from "equity-financed lending activity" is treated as nonpassive income to the extent of the lesser of the equity-financed interest income or net passive income. An activity is an "equity-financed lending activity" for a tax year if (1) the activity involves a trade or business of lending money; and (2) the average outstanding balance of the liabilities incurred in the activity for the tax year does not exceed 80% of the average outstanding balance of the interest-bearing assets held in the activity.

Incidental rental of property by development activity. Where gains on the sale of rental property are attributable to recent development, passive income treatment may be lost if the sale comes within the following tests: (1) the rental started less than 12 months before the date of disposition; and (2) you materially participated or significantly participated in the performance of services enhancing the value of the property. The 12-month period starts at the completion of the development services that increased the property's value.

Rental of property with an insubstantial depreciable basis. This rule prevents you from generating passive rental income with vacant land or land on which a unit is constructed that has a value substantially less than the land. If less than 30% of the basis of rental property is depreciable, and you have net passive income from rentals (taking into account carried-over passive losses from prior years), the net passive income is treated as nonpassive income. Basis here is generally adjusted basis without any adjustments.

EXAMPLES

1. A limited partnership buys vacant land for $300,000, constructs improvements on the land at a cost of $100,000, and leases the entire property. After the rental period, the partnership sells the property for $600,000, realizing a gain. The unadjusted basis of the depreciable improvements of $100,000 is only 25% of the basis of the property of $400,000. The rent and the gain allocated to the improvements is treated as nonpassive income to the extent you have net passive income for the year.
2. In 1989, Shirley offset a passive rental loss from an investment in a limited partnership, LP, which was a substantial owner of a general partnership, GP, against rental income from an investment in a joint venture, JV. JV had leased to GP land on which GP constructed a shopping center. The IRS held that the rental income from JV was nonpassive rental income within the 30% test and could not be offset by the passive rental loss. The Tax Court agreed and also rejected Shirley's attempt to aggregate her investment activities in JV and LP as one activity. The operations of each group, JV, LP, and GP, were separate and not owned by the same person. She was not the direct owner of any of the units. Further, the aggregation rule does not apply to property falling within the 30% test.

Property rented to nonpassive activity (self-rental property). You may not generate passive income by renting property to a business in which you materially participate.

Licensing of intangible property. Your share of royalty income in a partnership, S corporation, estate, or trust is treated as nonpassive income if you invested after the organization created the intangible property, performed substantial services, or incurred substantial costs in the development or marketing of it. *See* Publication 925 for further details.

¶10.10 Working Interests in Oil and Gas Wells

Working interests are generally not treated as passive activities. This is true whether you hold your interest directly or through an entity, provided your liability is not limited. As long as you have unlimited liability, you need not materially participate in the activity. A working interest is one burdened with the financial risk of developing and operating the property, such as a share in tort liability (for example, uninsured losses from a fire); some responsibility to share in additional costs; responsibility for authorizing expenses; receiving periodic reports about drilling, completion, and expected production; and the possession of voting rights and rights to continue operations if the present operator steps out.

Limited liability. If you hold a working interest through any of the following entities, the entity is considered to limit your liability and you are subject to the passive loss rules: (1) a limited partnership interest in a partnership in which you are not a general partner;

(2) stock in a corporation; or (3) an interest in any entity other than a limited partnership or corporation that, under applicable state law, limits the liability of a holder of such interest for all obligations of the entity to a determinable fixed amount.

The following forms of loss protection are disregarded and, thus, are not treated as limiting your liability: protection against loss by an indemnification agreement; a stop-loss agreement; insurance; or any similar arrangement or combination of agreements.

Working interests are considered on a well-by-well basis. Rights to overriding royalties or production payments, and contract rights to extract or share in oil and gas profits without liability for a share of production costs, are not working interests.

¶10.11 Partnership Rules

If you are a partner, your level of personal participation in partnership activity during the partnership year determines whether your share of income or loss is passive or nonpassive. Generally, limited partners are subject to passive activity treatment, but there are some exceptions. On Schedule K-1 of Form 1065, the partnership will identify each activity it conducts and specify the income, loss, deductions, and credits from each activity.

EXAMPLE

Don Bailey is a general partner of a fiscal year partnership that ends on March 31, 1996. During that fiscal year he was inactive. Since he did not materially participate, his share of partnership income or loss reported in 1996 is passive activity income or loss, even if he becomes active from April 1, 1996, to the end of 1996.

Not treated as passive income are payments for services and certain guaranteed payments made in liquidation of a retiring or deceased partner's interest unless attributed to unrealized receivables and goodwill at a time the partner was passive.

Gain or loss on the disposition of a partnership interest may be attributed to different trade, investment, or rental activities of the partnership. The allocation is made according to a complicated formula included in IRS regulations.

Payments to a retired partner. Gain or loss is treated as passive only to the extent that it would be treated as such at the start of the liquidation of the partner's interest.

Limited partners. A limited partner is generally not considered to be a material participant in a partnership activity, and, thus, treats income or loss as passive, except in these cases:

1. The limited partner participates for more than 500 hours during the tax year; *see* Test 1 in ¶10.6.
2. The limited partner materially participated in the partnership during prior years under either Test 5 or Test 6 at ¶10.6.
3. The limited partner is also a general partner at all times during the partnership tax year that ends with or within the partner's taxable year.

To determine material participation in rental real estate activities under the special rules for real estate professionals, Test 1 or Test 5 of ¶10.6 must generally be met, but *see* the exception at ¶10.3.

A limited partner is not considered to be an "active participant" and thus does not qualify for the $25,000 rental loss allowance under ¶10.2.

Publicly traded partnerships (PTPs). A PTP is a partnership whose interests are traded on established securities exchanges or are readily tradable in secondary markets. PTPs were organized to provide passive income to investors who could use the income to offset passive activity losses incurred from other activities. To defeat this tax purpose the tax law prevents offset of PTP income against net losses from any other passive activity or other PTP. Unallowed losses from a PTP carry forward and become deductible in a tax year only when you have passive income from that same PTP or dispose of your interest in that PTP. Follow the instructions on Form 8582 for reporting net PTP income or loss on Schedule E.

These passive activity rules apply to PTPs publicly traded on December 17, 1987, or which by that date had filed a PTP regulation statement with the SEC or an application with a state regulatory commission to restructure part of a corporation as a PTP. A PTP not meeting the December 17, 1987, test is generally taxed as a corporation; income or loss does not pass through to the partners. However, corporate treatment does not apply if 90% or more of PTP gross income is from interest, dividends, real property rents, property sales, and other passive types of income.

¶10.12 Form 8582

The purpose of Form 8582 is to assemble in one place items of income and expenses from passive activities in order to determine the effect of the passive loss rules on these items. After this determination, income and allowable deductions are reported as regular income and deductions in appropriate schedules attached to your tax return. For example, net profits of a self-employed person who is not active in the business are reported on Schedule C, sales of capital assets of a passive activity are reported on Schedule D, your share of partnership income and allowable deductions is reported on Schedule E, rental income and allowable deductions are reported on Schedule E.

Schedule D or Form 4797. Gains or losses from the sale of assets from a passive activity or from the sale of a partial interest which is less than "substantially all" of your entire interest in a passive activity are reported on Schedule D or on Form 4797 (sale of business property, *see* Chapter 44). The gain is also entered on Form 8582. Losses must first be entered on Form 8582 to see how much, if any, is allowable under the passive loss restrictions before an amount can be entered as a loss on Schedule D or Form 4797.

A disposition of an insubstantial part of your interest in the activity does not allow a deduction of suspended passive losses from prior years. When you dispose of your *entire* interest in a passive activity to a nonrelated party in a fully taxable transaction, your losses for the year plus prior year suspended losses from the activity

are fully deductible. The same rule applies to a partial disposition only if you are disposing of *substantially all* of the activity and you have proof of the current year and prior year suspended losses allocable to the disposed-of portion. You net the gain or loss from the disposition with the net income or loss from current year operations and any prior year suspended passive losses. If the netting gives you an overall gain, you need to file Form 8582 only if you have other passive activities. If you have an overall loss after the netting, you do not file Form 8582.

Schedule E. If you have a net profit from rental property or other passive activity reported on Schedule E and you also have losses from other passive activities, the income reported on Schedule E is also entered on Form 8582. A net loss from rental activities generally must be entered on Form 8582 but Form 8582 is not needed if you qualify for the full $25,000 allowance (¶10.2) for rental real estate losses and meet these tests:

- Your only passive activities are rental real estate activities and you have no suspended prior year passive losses from such activities;
- You have no credits related to passive activities;
- You actively participated in the rental real estate operations;
- Your total losses from the rental real estate activities are $25,000 or less ($12,500 or less if married filing separately and you lived apart from your spouse all year);
- Your modified adjusted gross income is $100,000 or less ($50,000 or less if married filing separately and you lived apart from your spouse all year); and
- You do not own any interest in a rental real estate activity as a limited partner or beneficiary of a trust or estate.

If you have a loss from a passive interest in a partnership, trust, estate, or S corporation, you first determine on Form 8582 whether the loss is deductible on Schedule E.

Schedule F. A passive activity farm loss is entered on Form 8582 to determine the deductible loss. If only part of the loss is allowed, only that portion is claimed on Schedule F. A net profit from passive farm activities is also entered on Form 8582 to offset losses from other passive activities.

Other tax forms. Other forms tied to Form 8582 are Form 4797 (sale of business assets or equipment), Form 4835 (farm rental income), and Form 4952 (investment interest deductions). For further details *see* Form 8582; also *see* IRS Publication 925 for filled-in sample forms.

¶10.13 Suspended Losses Allowed on Disposition of Your Interest

Losses and credits that may not be claimed in 1996 because of the passive activity limitations are suspended and carried forward to 1997 and later years. The carryover lasts indefinitely, until you have passive income against which to claim the losses and credits. No carryback is allowed. What if you have suspended losses and later materially participate in the business in which the loss was realized? The losses remain as passive losses but may offset nonpassive income of that activity.

EXAMPLE

In 1996, Nick Milo was not a material participant in a business activity and his share of losses was $10,000, which was suspended because he had no passive income. In 1997, he becomes a material participant in the business and his share of income is $1,000. The $1,000 is treated as nonpassive income, and he may apply $1,000 of the suspended loss to offset that income.

Allocation of suspended loss. If your suspended loss is incurred from several activities, you allocate the loss among the activities using the worksheets accompanying Form 8582. The loss is allocated among the activities in proportion to the total loss. If you have net income from significant participation activities (Test 4 of ¶10.6), such activities may be treated as one single activity in making the allocation; *see* instructions to Form 8582.

Disposition of a passive interest. A fully taxable sale of your interest to a nonrelated person will allow you to claim suspended deductions from the activity. Worthlessness of a security in a passive activity is treated as a disposition. An abandonment also releases suspended losses.

On a disposition, the suspended losses plus any current year income or loss from the activity are combined with the gain or loss from the disposition; *see* the Examples on the next page and follow the instructions to Form 8582 for reporting the net gain or loss.

Partial Disposition. You may for the taxable year in which there is a disposition of *substantially all* of an activity treat the part disposed of as a separate activity. You must show: (1) the amount of prior year suspended deductions and credits allocable to that part of

the activity for the taxable year, and (2) the amount of gross income and any other deductions and credits allocable to that part of the activity for the taxable year.

$3,000 capital loss limit. Capital losses incurred on a disposition of a passive interest are also subject to the general $3,000 loss limitation of ¶5.3.

EXAMPLES

1. Jill Stein has a 5% interest in a limited partnership with an adjusted basis of $42,000. In 1996, she sells her interest in the partnership to an unrelated person for $50,000. For 1996, she has a current year loss from the partnership (shown on Schedule K-1) of $3,000. She also has $2,000 of suspended passive losses from prior years that have been carried forward to 1996. Jill's $8,000 gain from the sale of her interest is combined on Form 8582 with the current year loss and suspended losses giving her an overall gain of $3,000, figured as follows:

Sales price		$50,000
Less: Adjusted basis		42,000
Gain		$8,000
Less: Current year loss	$3,000	
Suspended losses	2,000	$ 5,000
Overall gain		$ 3,000

If Jill has *other* passive activities, the $8,000 gain would be reported as current year income on Form 8582. The $3,000 current year loss and $2,000 suspended losses would also be entered on Form 8582.

If this was Jill's *only* passive activity, she does not have to file Form 8582. The gain from the sale is reported on Schedule D and the current year and suspended losses are reported as nonpassive losses on Schedule E.

2. Assume that Jill's suspended losses from prior years were $10,000 instead of $2,000. She has an overall loss of $5,000 after combining the gain from the sale of $8,000, the current year loss of $3,000, and the suspended losses of $10,000.

Since there is an overall loss after combining the gain and losses, Jill does not file Form 8582. The current year loss plus the suspended losses are reported as nonpassive losses on Schedule E and the gain from the disposition on Schedule D.

3. Assume in Example 1 that Jill sold her interest for $30,000 instead of $50,000. She would have a $12,000 loss on the sale ($42,000 adjusted basis *less* $30,000 sales price). Combining the loss with the current year loss of $3,000 and the $2,000 of suspended losses, she has an overall loss of $17,000.

Since there is an overall loss, Jill does not file Form 8582. The current year loss plus the suspended losses are reported as nonpassive losses on Schedule E. The $12,000 loss on the sale is reported on Schedule D as a capital loss. Under the regular rules for capital losses, the loss will offset capital gains for 1996 and any excess will be deductible only up to $3,000 (¶5.3). Assuming the $3,000 limit applies, Jill has a $9,000 capital loss carryover to 1997.

Gifts. When a passive activity interest is given away, you may not deduct suspended passive losses. The donee's basis in the property is increased by the suspended loss if he or she sells the property at a gain. If a loss is realized by the donee on a sale of the interest, the donee's basis may not exceed fair market value of the gift at the time of the donation.

Death. On the death of an investor in a passive interest, suspended losses are deductible on the decedent's final tax return, to the extent the suspended loss exceeds the amount by which the basis of the interest in the hands of the heir is increased.

EXAMPLE

An owner dies holding an interest in a passive activity with a suspended loss of $8,000. After the owner's death, the heir's stepped-up basis for the property (equal to fair market value) is $6,000 greater than the decedent's basis. On the decedent's final return, $2,000 of the loss is deductible ($8,000 – $6,000).

Installment sales. If the passive activity interest is sold at a profit on the installment basis, suspended losses are deducted over the installment period in the same ratio as the gain recognized each year bears to the gain remaining to be recognized as of the start of the year. For example, if in the year of sale you report 20% of your total gain under the installment method, 20% of your suspended losses are also allowed.

¶10.14 Suspended Tax Credits

If you have tax credits that were barred under the passive activity rules, they may be claimed only in future years when you have tax liability attributable to passive income. However, in the year you dispose of your interest, a special election may be available to decrease your gain by the amount of your suspended credit; *see* below.

Basis election for suspended credits. If you qualify for an investment credit (under transition rules) or a rehabilitation credit, you are required to reduce the basis of the property even if you are unable to claim the credit because of the passive activity rules. If this occurs and you later dispose of your entire interest in the passive activity, including the property whose basis was reduced, your gain will be increased by virtue of the basis reduction although you never benefited from the credit. To prevent this, you may reduce the taxable gain by electing to increase the pre-transfer basis of the property by the amount of the unused credit.

EXAMPLE

Dan Brown places in service rehabilitated credit property qualifying for a $50 credit, but the credit is not allowed under the passive loss rules. However, his basis is still reduced by $50. In a later year, Brown makes a taxable disposition of his entire interest in the activity and in the rehabilitation property. Assuming that no part of the suspended $50 credit has been used, Brown may elect to increase his basis in the property by the unused $50 credit.

¶10.15 Personal Service and Closely Held Corporations

To prevent avoidance of the passive activity rules through use of corporations, the law imposes restrictions on income and loss offsets in closely held C corporations and personal service corporations.

Unless the material participation tests discussed in this section are met, the activities of a personal service corporation or a closely held corporation are considered passive activities, subject to the restrictions on loss deductions and tax credits. For purposes of these passive activity rules, a closely held C corporation is a corporation in which more than 50% in value of the stock is owned by five or fewer persons during the last half of the tax year.

A personal service corporation is a C corporation the principal activity of which is the performance of personal services by the employee-owners. Personal services are services in the fields of health, law, engineering, architecture, accounting, actuarial sciences, performing arts, or consulting. An employee-owner is any employee who on any day in the tax year owns any stock in the corporation. If an individual owns any stock in a corporation which in turn owns stock in another corporation, the individual is deemed to own a proportionate part of the stock in the other corporation. Further, more than 10% of the corporation's stock by value must be owned by owner-employees for the corporation to be a personal service corporation.

Material participation. A personal service corporation or closely held corporation is treated as materially participating in an activity during a tax year *only if* either:

1. One or more stockholders are treated as materially participating in the activity and they directly or indirectly hold in the aggregate more than 50% of the value of the corporation's outstanding shares; *or*
2. The corporation is a closely held corporation and in the 12-month period ending on the last day of the tax year, the corporation had at least one full-time manager, three full-time manager employees, none of whom own more than 5% of the stock, and business deductions exceeded 15% of gross income from the activity.

A stockholder is treated as materially participating or significantly participating in the activity of a corporation if he or she satisfies one of the seven tests in ¶10.6 for material participation. For purposes of applying the significant participation test (Test 4 at ¶10.6), an activity of a personal service or closely held corporation is treated as a significant participation activity for a tax year *only if*:

1. The corporation is not treated as materially participating in the activity for the tax year; and
2. One or more individuals, each of whom is treated as significantly participating in the activity directly or indirectly, hold in the aggregate more than 50% of the value of the outstanding stock of the corporation. Furthermore, in applying the seven participation tests, all activities of the corporation are treated as activities in which the individual holds an interest in determining whether the individual participates in an activity of the corporation; and the individual's participation in all activities other than activities of the corporation is disregarded in determining whether his or her participation in an activity of the corporation is treated as material participation under the significant participation test (Test 4 at ¶10.6).

Closely held corporation's computation of passive loss. Even if a closely held corporation does *not* meet the material participation tests above, it still qualifies for a slight break from the passive loss restrictions. A closely held corporation may use passive activity deductions to offset not only passive activity gross income but also *net active income*. Generally, net active income is taxable income from business operations, disregarding passive activity income and expenses, and also disregarding portfolio income and expenses; *see* ¶10.8. Passive activity losses cannot offset portfolio income.

If a corporation stops being closely held, its passive losses and credits from prior years are not allowable against portfolio income but continue to be allowable only against passive income and net active income.

Tax liability on net active income may be offset by passive activity credits.

¶10.16 Sales of Property and of Passive Activity Interests

Generally, gain on the sale or disposition of property is passive or nonpassive, depending on whether your activity is passive or nonpassive in the year of sale or disposition. Thus, gain on the sale of property used in a rental activity is treated as passive income, and gain on property used in a nonrental business is passive if you did not materially participate in the business in the year of sale. However, exceptions may prevent you from generating passive income by arranging certain sales described in this section. For example, gain on the sale of substantially appreciated property formerly used in a nonpassive activity may be treated as nonpassive income, even if sold by a passive activity.

Where you transact an installment sale, treatment of gain in later years depends on your status in the year of sale. For example, if you were considered a material participant in a business, all gain is treated as nonpassive income, including gain for later installments. If you were in a rental activity or were not a material participant in a nonrental business, the gain is treated as passive income, unless the exceptions in this section apply.

Current gain from a pre-1987 installment sale is passive income if the activity would have been passive, assuming the passive activity rules were in effect at the time of the sale.

Gain on appreciated property formerly used in nonpassive activity. Gain from a disposition of substantially appreciated property is treated as passive activity income if the property was used in a passive activity for either 20% of its holding period or the entire 24-month period ending on the date of the disposition. Property is substantially appreciated if fair market value exceeds 120% of its adjusted basis.

EXAMPLE

In 1989, Andy Jones buys a building for use in a business in which he materially participates until March 31, 1999. On April 1, 2000, he rents the building. On December 31, 2001, he sells the building. Gain from the sale is treated as not from a passive activity. The building was used in a passive rental activity for 21 months before disposition (April 1, 2000, through December 31, 2001). Thus, it was not used in a passive activity for the entire 24-month period ending on the date of the sale. Further, the 21-month period during which the building was used in a passive activity is less than 20% of Jones's holding period of 12 years.

Property used in more than one activity in a 12-month period preceding disposition. You are required to allocate the amount realized on the disposition and the adjusted basis of the property among the activities in which the property was used during a 12-month period preceding the disposition. For purposes of this rule, the term "activity" includes personal use and holding for investment. The allocation may be based on the period for which the property is used in each activity during the 12-month period. However, if during the 12-month period the value of the property does not exceed the lesser of $10,000 and 10% of the value of all property used in the activity at the time of disposition, gain may be allocated to the predominant use.

EXAMPLE

Joe Smith sells a personal computer for $8,000. During the 12-month period that ended on the date of the sale, 70% of Smith's use of the computer was in a passive activity. Immediately before the sale, the fair market value of all property used in the passive activity, including the personal computer, was $200,000. The computer was predominantly used in the passive activity during the 12-month period ending on the date of the sale. The value of the computer, $8,000, did not exceed the lesser of $10,000 and 10% of the $200,000 value of all property used in the activity immediately before the sale. Thus, the amount realized and the adjusted basis are allocated to the passive activity.

Disposition of partnership and S corporation interests. Gain or loss from the disposition of an interest in a partnership and S corporation is generally allocated among the entity's activities in proportion to the amount that the entity would have allocated to the partner or shareholder for each of its activities if the entity had sold its interest in the activities on an "applicable valuation date."

Gain is allocated only to appreciated activities. Loss is allocated only to depreciated activities. The entity may select either the beginning of its tax year in which the holder's disposition occurs or the date of the disposition as the applicable valuation date.

Claiming suspended loss on disposition of interest in passive activity. A fully taxable sale of your entire interest or of substantially all of your interest to a nonrelated person will allow you to claim suspended loss deductions from the activity. These rules are fully discussed in ¶10.13.

Dealer's sale of property similar to property sold in the ordinary course of business. IRS regulations set down complex tests which determine whether the result of the sale is treated as passive or nonpassive income or loss.

At-Risk Rules

¶10.17 At-Risk Limits

The at-risk rules prevent investors from claiming losses in excess of their actual tax investment by barring them from including nonrecourse liabilities as part of the tax basis for their interest. Almost all ventures are subject to the at-risk limits. Real estate placed in service after 1986 is subject to at-risk rules as well, but most real estate nonrecourse financing can qualify for an exception; *see* ¶10.18.

EXAMPLE

Crystal Parker invests cash of $1,000 in a venture and signs a nonrecourse note for $8,000. In 1996, her share of the venture's loss is $1,200. The at-risk rules limit her deduction to $1,000, the amount of her cash investment; as she is not personally liable on the note, the amount of the liability is not included as part of her basis for loss purposes.

Losses disallowed under the at-risk rules are carried over to the following year; *see* ¶10.21.

Form 6198. If you have amounts that are not at risk, you must file Form 6198 to figure your deductible loss. A separate form must be filed for each activity. However, if you have an interest in a partnership or S corporation that has more than one investment in any of the following four categories, the IRS currently allows you to aggregate all of the partnership or S corporation activities within each category. For example, all partnership or S corporation films and videotapes may be treated as one activity in determining amounts at risk. The aggregation rules may be changed by the IRS; *see* the instructions to Form 6198.

1. Holding, producing, or distributing motion picture films or videotapes;
2. Exploring for or exploiting oil or gas properties;
3. Exploring for, or exploiting, geothermal deposits (for wells commenced on or after October 1, 1978); and

4. Farming. For this purpose, farming is defined as the cultivation of land and the raising or harvesting of any agricultural or horticultural commodity—including raising, shearing, breeding, caring for, or management of animals. Forestry and timber activities are not included, but orchards bearing fruits and nuts are within the definition of farming. Certain activities carried on within the physical boundaries of the farm may not necessarily be treated as farming.

In addition to the previous categories, the law treats as a single activity all leased depreciable business equipment (Section 1245 property) that is placed in service during any year by a partnership or S corporation.

Exempt from the at-risk rules are C corporations which meet active business tests and are not in the equipment leasing business or any business involving master sound recording, films, videotapes, or other artistic, literary, or musical property. For details on the active business tests, as well as a special at-risk exception for equipment leasing activities of closely held corporations, *see* IRS Publication 925.

The at-risk limitation applies only to tax losses produced by expense deductions which are not disallowed by reason of another provision of the law. For example, if a prepaid interest expense is deferred under the prepaid interest limitation (¶15.14), the interest will not be included in the loss subject to the risk limitation. When the interest accrues and becomes deductible, the expense may be considered within the at-risk provision. Similarly, if a deduction is deferred because of farming syndicate rules, that deduction will enter into the computation of the tax loss subject to the risk limitation only when it becomes deductible under the farming syndicate rules.

Effect of passive loss rules. Where a loss is also subject to the at-risk rules, you apply the at-risk rules first. If the loss is deductible under the at-risk rules, the passive activity rules then apply. On Form 6198 (at risk), you figure the deductible loss allowed as at risk and then carry the loss over to Form 8582 to determine the passive activity loss.

¶10.18 What Is At Risk?

The following amounts are considered at risk in determining your tax position in a business or investment:

Cash;
Adjusted basis of property that you contribute; and
Borrowed funds for which you are personally liable to pay.

At-risk basis is figured as of the end of the year. Any loss allowed for a year reduces the at-risk amount as of the start of the next year. Therefore, if a loss exceeds your at-risk investment, the excess loss will not be deductible in later years unless you increase your at-risk investment; *see* ¶10.21.

Personal liability alone does not assure that the borrowed funds are considered at risk. The lender must have no interest in the venture other than as creditor.

EXAMPLE

Julie Kahn, an investor, pays a promoter of a book purchase plan $45,000 for a limited partnership interest. The promoter is the general partner. Kahn pays $30,000 cash and gives a note for $15,000 on which she is personally liable. Her amount at risk is $30,000; the $15,000 personal liability note is not counted because it is owed to the general partner.

Special at-risk rule for real estate financing. For real property placed in service after 1986, you may treat nonrecourse financing from unrelated commercial lenders or from government agencies as amounts at risk if the financing is secured by the real estate. Loans from the seller or promoter do not qualify. Third-party nonrecourse debt from a related lender, other than the seller or a promoter, may also be treated as at risk, providing the terms of the loan are commercially reasonable and on substantially the same terms as loans involving unrelated persons.

If you acquired an interest after 1986 in a partnership or S corporation, the above at-risk rules apply to your share of real estate losses, regardless of when the partnership or S corporation placed the property in service.

Pledges of other property. If you pledge personally owned real estate used outside the activity to secure a nonrecourse debt and invest the proceeds in an at-risk activity, the proceeds may be considered part of your at-risk investment. The proceeds included in basis are limited by the fair market value of the property used as collateral (determined as of the date the property is pledged as security) less any prior (or superior) claims to which the collateral is subject.

Partners. A partner is treated as at risk to the extent that basis in the partnership is increased by the share of partnership income. That partnership income is then used to reduce the partnership's nonrecourse indebtedness will have no effect on a partner's amount at risk. If the partnership makes actual distributions of the income in the taxable year, the amount distributed reduces the partner's amount at risk. A buy-sell agreement, effective at a partner's death or retirement, is not considered for at-risk purposes.

EXAMPLES

1. On January 2, 1994, Paul Reed, an investor, contributes $5,000 cash to a farming venture. He also borrows $3,000 from a bank for which he is personally liable and contributes it. By the end of 1994, he pays off $750 of the loan. The venture has no income or losses in 1994. His at-risk basis as of December 31, 1994, is $7,250, determined as follows:

Contributions	$ 5,000
Recourse financing	3,000
	$ 8,000
Less: Partial loan repayment	750
Amount at risk as of 12/31/94	$ 7,250

2. Same as Example 1, but on February 1, 1995, he borrows $10,000 on a nonrecourse basis. He pays off $1,000 on the personal liability loan and $500 on the nonrecourse loan. The venture earns $3,000 and distributes $2,000 to him. The at-risk basis as of December 31, 1995, is $7,250, determined as follows:

Amount at risk as of 1/1/95		$ 7,250
Plus: Income		3,000
		$10,250
Less: Repayment of personal liability loan	$1,000	
Distribution	2,000	3,000
Amount at risk as of 12/31/95		$ 7,250

Payment on the nonrecourse loan with funds or other nonrecourse loans from only the activity does not affect the amount at risk.

3. Same as Example 2, but on March 1, 1996, the investor contributes $2,500 and pays off the personal liability loan. The venture has losses of $10,500 for 1996. As of December 31, 1996, the investor's amount at risk is $8,500, determined as follows:

Amount at risk as of 1/1/96	$7,250
Plus: Contribution	2,500
	$9,750
Less: Payment of personal liability loan	1,250
Amount at risk as of 12/31/96	$8,500

The investor's loss deduction is limited to the amount at risk of $8,500. The $2,000 disallowed loss is carried over to 1997.

Note: The above adjustments to basis are only for at-risk purposes. Basis for depreciation and computing gain or loss on a sale is controlled by the adjusted basis rules at ¶5.20.

Activities begun before 1976. A special rule determines the amount at risk as of the first day of the first tax year after 1975. Again, you start with the amounts considered at risk. Losses incurred and deducted in taxable years before 1976 first reduce the basis allocated to amounts considered not at risk, such as nonrecourse loans. If the losses exceed the amount not at risk, the excess reduces the at-risk investment. Distributions reduce at-risk amounts. *See* the instructions to Form 6198.

¶10.19 Amounts Not At Risk

The following may not be treated as part of basis for at-risk purposes in determining your tax position in a business or investment:

Liabilities for which you have no personal liability, except in the case of certain real estate financing; *see* ¶10.18.

Liabilities for which you have personal liability, but the lender also has a capital or profit-sharing interest in the venture.

Recourse liabilities convertible to a nonrecourse basis.

EXAMPLE

David Krepp, an investor, purchases cattle from a rancher for $10,000 cash and a $30,000 note payable to the rancher. Krepp is personally liable on the note. In a separate agreement, the rancher agrees to care for the cattle for 6% of Krepp's net profits from the cattle activity. Krepp is considered at risk for $10,000; he may not increase the amount at risk by the $30,000 borrowed from the rancher.

Money borrowed from a relative listed at ¶33.10 who has an interest in the venture, other than as a creditor, or from a partnership in which you own more than a 10% interest.

Funds borrowed from a person whose recourse is either your interest in the activity or property used in the activity.

Amounts for which your economic loss is limited by a nonrecourse financing guarantee, stop-loss agreement, or other similar arrangement.

Investments protected by insurance or loss reimbursement agreement between you and another person. If you are personally liable on a mortgage but you separately obtain insurance to compensate you for any mortgage payments, you are at risk only to the extent of the uninsured portion of the personal liability. You may, however, include as at risk any amount of premium paid from your personal assets. Taking out casualty insurance or insurance protecting you against tort liability is not considered within the at-risk provisions, and such insurance does not affect your investment basis.

EXAMPLES

1. Some commercial feedlots in livestock feeding operations may reimburse investors against any loss sustained on sales of the livestock above a stated dollar amount per head. Under such "stop-loss" orders, an investor is at risk only to the extent of the portion of his or her capital against which he or she is not entitled to reimbursement. Where a limited partnership makes an agreement with a limited partner that, at the partner's election, his or her partnership interest will be bought at a stated minimum dollar amount (usually less than the investor's original capital contribution), the partner is considered at risk only to the extent of his or her investment exceeding the guaranteed repurchase price.

2. A TV film promoter sold half-hour TV series programs to individual investors. Each investor gave a cash down payment and a note for which he or she was personally liable for the balance. Each investor's note, which was identical in face amount, terms, and maturity date, was payable out of the distribution proceeds from the film. Each investor also bought from the promoter the right to the unpaid balance on another investor's note. The promoter arranged the distribution of the films as a unit and was to apportion the sales proceeds equally among the investors.

   The IRS held that each investor is not at risk on the investment evidenced by the note. Upon maturity, each may receive a payment from another investor equal to the one that he or she owes.

3. A gold mine investment offered tax write-offs of four times the cash invested. For $10,000 cash, an investor buys from a foreign mining company a seven-year mineral claim lease to a gold reserve. Under the lease, he or she can develop and extract all of the gold in the reserve. At the same time, he or she agrees to spend $40,000 to develop the lease before the end of the year. To fund this commitment, the investor authorizes the promoter to sell an option for $30,000 to a third party who is to buy all the gold to be extracted. The $30,000 along with the $10,000 down payment is to be used to develop the reserve. The promoter advises the investor that he or she may claim a $40,000 deduction for certain development costs.

   The IRS ruled that $30,000 is not deductible because the amount is not "risk capital." The investor gets $30,000 by selling an option that can be exercised only if gold is found. If no gold is found, he or she is under no obligation to the option holder. His or her risk position for the $30,000 is substantially the same as if he or she had borrowed from the option holder on a nonrecourse basis repayable only from his or her interest in the activity.

   The Tax Court struck down a similar plan on different grounds. Without deciding the question of what was at risk, the court held that the option was only a right of first refusal. Thus, $30,000 was taxable income to the investor in the year of the arranged sale.

Limited partner's potential cash call. Under the terms of a partnership agreement, limited partners may be required to make additional capital contributions under specified circumstances. Whether such a potential cash call increases the limited partner's at-risk amount has been a matter of dispute.

In one case, the IRS and Tax Court held that a limited partner was not at risk with respect to a partnership note where, under the terms of the partnership agreement, he could be required to make additional capital contributions if the general partners did not pay off the note at maturity. The possibility of such a potential cash call was too uncertain; the partnership might earn profits to pay off the note and even if there were losses, the general partners might not demand additional contributions from the limited partners.

However, a federal appeals court reversed, holding that the limited partner was at risk because his obligation was mandatory and "economic reality" insured that the general partners would insure their rights by requiring the additional capital contribution.

In another case, limited partners relied upon the earlier favorable federal appeals court decision to argue that they were at risk where they could be required by the general partners to make additional cash contributions, but only in order to cover liabilities or expenses that could not be paid out of partnership assets. So long as the partnership was solvent, the limited partners could "elect out" of the call provision. Because of this election, the Tax Court held that the limited partners' obligation was contingent, rather than unavoidable as in the earlier federal appeals court case. Thus, the cash call provision did not increase their at-risk amount.

¶10.20 At-Risk Investment in Several Activities

If you invest in several activities, each is generally treated separately when applying the at-risk limitation on Form 6198. You generally may not aggregate basis, gains, and losses from the activities for purposes of at-risk limitations. Thus, income from one activity may not be offset by losses from another; the income from one must be reported while the losses from the other may be nondeductible because of at-risk limitations.

However, you may aggregate activities that are part of a business you actively manage. Activities of a business carried on by a partnership or S corporation qualify if 65% or more of losses for the year are allocable to persons who actively participate in management.

The law allows partnerships and S corporations to treat as a single activity all depreciable equipment (Section 1245 property) which is leased or held for lease and placed in service in any tax year. Furthermore, you may aggregate all partnership or S corporation activities within the four categories of films and videotapes, oil and gas properties, geothermal properties, and farms; see ¶10.17.

¶10.21 Carryover of Disallowed Losses

A loss disallowed in a current year by the at-risk limitation may be carried over and deducted in the next taxable year, provided it does not fall within the at-risk limits or the passive loss limits in that year. The loss is subject to an unlimited carryover period until there is an at-risk basis to support the deduction. This may occur when additional contributions are made to the business or when the activity has income which has not been distributed.

Gain from the disposition of property used in an at-risk activity is treated as income from the activity. In general, the reporting of gain will allow a deduction for losses disallowed in previous years to be claimed in the year of disposition.

¶10.22 Recapture of Losses Where At Risk Is Less Than Zero

To prevent manipulation of at-risk basis after a loss is claimed, there is a special recapture rule. If the amount at risk in an activity is reduced to below zero because of a distribution or a change in the status of an indebtedness from recourse to nonrecourse, income may be realized to the extent of the negative at-risk amount. The taxable amount may not exceed the amount of losses previously deducted.

The recaptured amount is not treated as income from the activity for purposes of determining whether current or suspended losses are allowable.

The recaptured amount is treated as a deduction allocable to that activity in the following year.